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Annex to
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West Germany Under New Leadership

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WEST GERMANY UNDER NEW LEADERSHIP

1. West German Chancellor Helmut Schmidt promises to take an even harder line against inflation than his predecessors. In doing so, he will meet with less political opposition than most Western leaders. Minister of Finance in the preceding government, Schmidt evidently is giving top priority to economic issues. He will not institute radical changes but apparently favors more restrictive fiscal measures to complement a continued tight monetary policy.

2. In his initial policy speech to the Bundestag last month, Schmidt left little doubt that some of Willy Brandt's popular and expensive social reforms would have to be sacrificed to a more frugal fiscal policy. He has charged new Minister of Finance Hans Apel with drafting a budget that has "no place for appropriations to satisfy exaggerated demands." Schmidt will also take a stronger stand than Brandt against inflationary wage increases.

3. West Germany is taking this austere line despite its ability to shift to the more expansionary policies that would be welcomed by countries experiencing large trade deficits. After more than a year of stagnant output, the economy has developed substantial excess capacity. Moreover, foreign reserves, at \$34 billion, are by far the world's largest. An expansionary policy thus should not be costly over the short term to the anti-inflation effort and would be well within Germany's foreign payments capabilities. But, because of deep-seated German fears of inflation, Schmidt seems unlikely to adopt stimulative measures until he feels that price pressures are well under control.

4. In dealing with fellow Community members, Schmidt probably will be less willing than Brandt to make economic concessions without visible returns. He views assistance to hard-pressed countries that are unwilling to adopt stabilization programs as politically unacceptable and economically unproductive. While reaffirming German dedication to EC unity, Schmidt - like his predecessors - brands as illusory any attempt to achieve economic and monetary union without policy harmonization. Close ties with French President Giscard will not necessarily resolve the deep-seated differences in objectives between two of the Community's most important members.

5. The new German Chancellor favors a strong Atlantic Alliance. Even more than in the past, Washington probably can count on earnest efforts by Bonn to harmonize US and EC economic interests. At the same time, he will expect the United States to take the lead in solving critical international problems.

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Current State of the Economy

6. Economic growth continues to be inhibited by the restrictive monetary policies initiated last year in response to accelerating inflation. In January-April 1974, GNP grew at a rate of about 1%, a far cry from last year's 5.3% gain. Since all of last year's growth occurred in the first quarter, West Germany has gone a year without appreciable economic expansion.

7. Output edged up earlier this year only because of increased exports and government consumption -- the same factors that kept GNP from dropping in the last nine months of 1973. Construction has not recovered from its slump, investment in general has continued to decline, and consumer buying is down. Overall domestic demand in fact declined by 2% or so in the first quarter. Exports, which jumped from an already record 33% to 38% of GNP, were by far the most dynamic factor in the economy.

8. Despite the strength of export sales, industrial production has sagged since November. Capacity utilization has fallen to about 85% -- the lowest level since early 1968 -- and apparently is still declining. The sharpest drop in production has occurred in the consumer durables industries, particularly automobiles. Germany's largest auto producers, Volkswagen and Opel, report sharply reduced sales, rapidly mounting stocks, and substantial short-time work.

9. Bonn's costly battle against inflation has held retail price rises far below those in other industrialized countries. Consumer prices in the first quarter rose at an annual rate of 6% from the end-1973 level. A 23% drop in agricultural wholesale quotations promised some relief from high food prices. Industrial wholesale prices shot up at an annual rate of 21%, however, as costs of imported raw materials soared. Wage hikes exceeding government guidelines also contributed to rising industrial costs.

10. Last winter's unemployment rate -- unusually high by West German standards -- is easing more slowly than expected. In May, 457,000 workers -- 2.1% of the labor force -- were still unemployed, compared with 620,000 workers in January. If adjusted for seasonal variations, however, the unemployment rate has climbed steadily during the first five months of this year. The number of unemployed workers continues to exceed job vacancies, and the number of workers on short time remains large.

11. Declining domestic demand has been a major factor allowing West Germany to chalk up record trade surpluses. Import volume actually fell by 5% in the first four months of 1974, compared with a year earlier, holding the rise in import value to 32%. Fed by orders taken before economic downturns abroad, exports grew by a remarkable 47% with about four-fifths of the rise owing to volume. As a result, the trade surplus through April exceeded \$8 billion, compared with \$4 billion in the same period last year.

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Short-Term Prospects

12. Barring an unexpected shift in the Schmidt government's policy, the short-term outlook is for slow growth, an inflation rate high by German standards but lower than most, and large trade surpluses. If it adheres to current stabilization policies, the government will be hard pressed to achieve even the 2% growth now forecast for 1974. In real terms, industrial orders have only begun to recover from their 15% plunge in the second half of last year. Flagging investment abroad is beginning to slow export orders for capital goods, threatening to offset any recovery in private investment.

13. Prospects for other sectors are mixed. Consumer attitudes remain negative, notwithstanding recent wage hikes averaging 16%. Injections of public funds into construction and other hard-hit industries should prop up demand, but output is not likely to grow much over the next few months. Industry will continue to operate far below capacity.

14. The government now believes that inflation can be held to 8% in 1974 rather than the 9%-10% forecast earlier in the year. The new goal appears reasonable in view of slack demand and declining raw material prices. Schmidt almost certainly will take a firmer position against labor leaders than Brandt did, to keep wage settlements from intensifying inflation. Unemployment probably will not become an important political issue if the rate drops later this year, as expected.

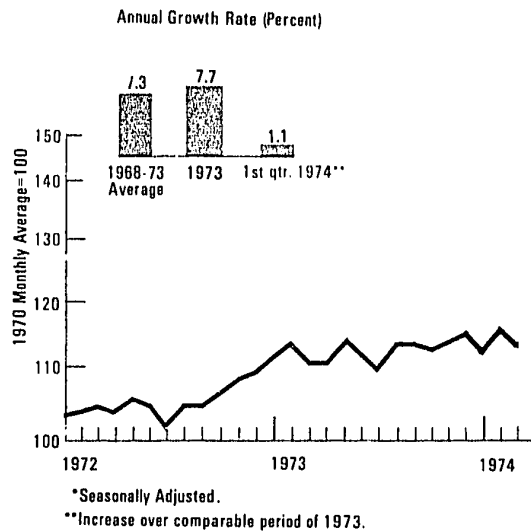
15. Although West Germany's trade surpluses are likely to decline in coming months, the surplus for the entire year probably will exceed last year's record \$16 billion. Forecasts of a \$10 billion surplus made during the oil supply crisis were based on expectations that foreign demand for German goods would drop quickly. A decline in export orders is just now beginning to appear and is being partly offset by increased prices. Moreover, because of industrial stagnation, German import demand probably will pick up later and less strongly than anticipated earlier.

16. Bonn's balance-of-payments performance will continue to be the envy of the Western world. With foreign workers' remittances and net tourist expenditures down, the current account surplus will at least match last year's \$4.7 billion and could be considerably higher. Bonn thus will come under increasing pressure from countries with large payments deficits to reduce its surplus and make part of its \$34 billion in reserves available to them.

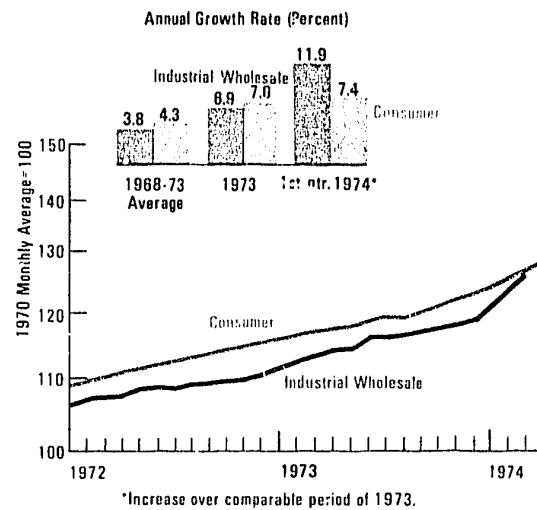
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WEST GERMANY: INTERNAL ECONOMIC INDICATORS

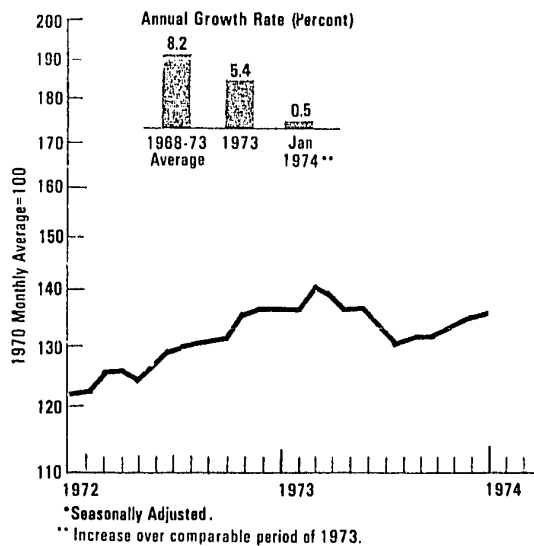
INDUSTRIAL PRODUCTION*



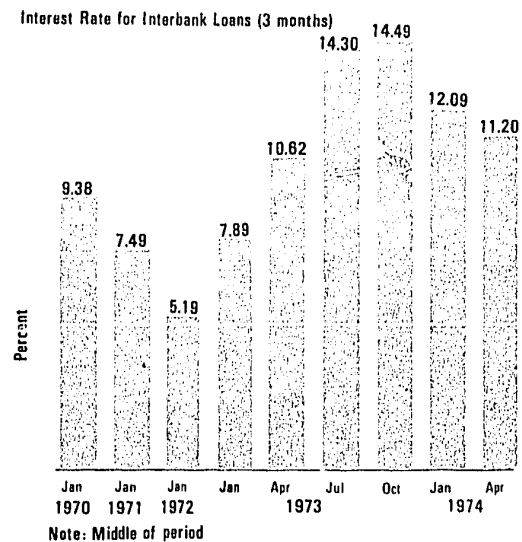
PRICES



MONEY SUPPLY*

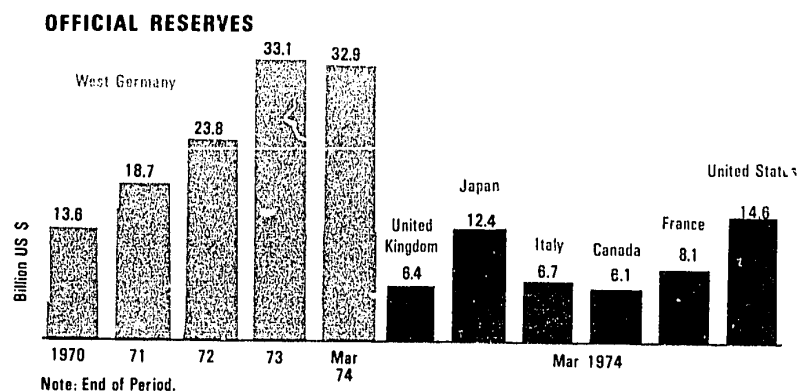
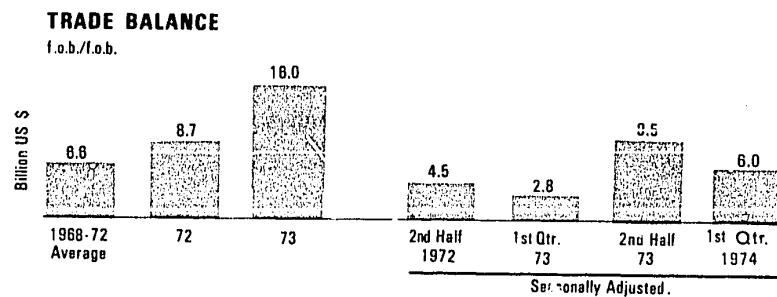
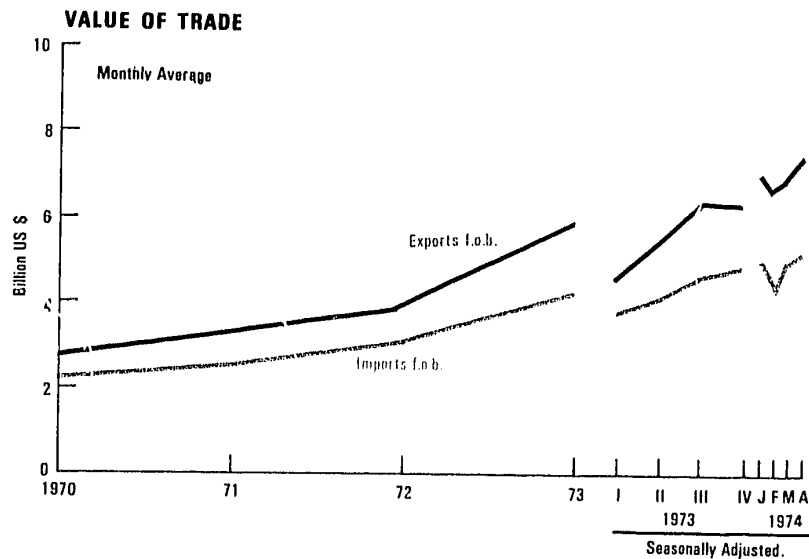


MONEY MARKET RATES



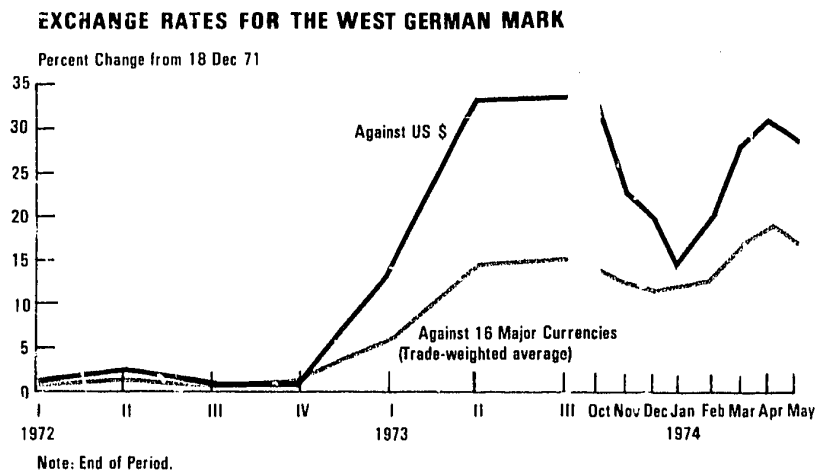
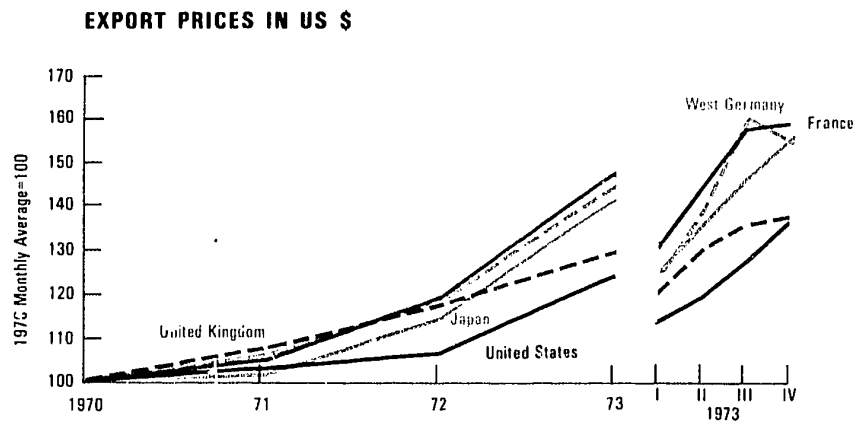
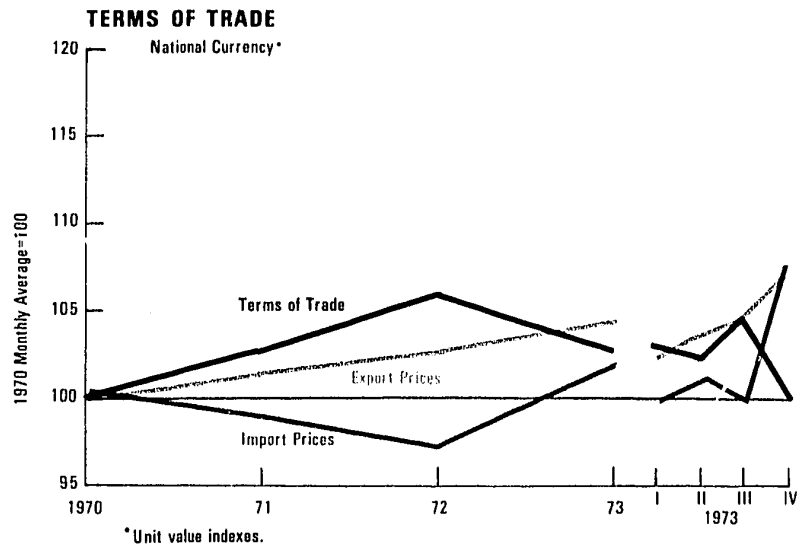
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